TEACHERS' RETIREMENT BOARD

BENEFITS AND SERVICES COMMITTEE

SUBJECT: OPTIONAL SUPPLEMENTAL BENEFITS STUDY

ITEM NUMBER: 4

ATTACHMENT(S): 1

ACTION: ________

MEETING DATE: April 2, 1998

INFORMATION: X

PRESENTER: Ms. DuCray-Morrill

The Teachers' Retirement Board (TRB) co-sponsored Assembly Bill 2648 (Karnette) with the California Teachers' Association in 1994 which would have required STRS to conduct a study to determine the feasibility of the System to offer certain optional supplemental benefits that members could elect to purchase. The Governor vetoed the bill. The veto message expressed the concern that while the bill provided for recovery of the $75,000 appropriation from the Teachers' Retirement Fund (TRF) from STRS members receiving a benefit enhancement, there was no assurance that the TRF would be fully reimbursed. Subsequently, the TRB agreed to undertake the study using its own resources.

The current retirement plans provide a level of security and include disability and survivor benefit coverage. As a means of enhancing current retirement plans and addressing the changing needs of the STRS membership, STRS contracted with Mercer, Inc. to assist staff in assessing whether optional supplemental benefits should be provided to the membership (see attached Final Report). Input was obtained from school districts, constituent groups, and active and retired members. A market analysis was also conducted.

We are providing this to you for information at this time to consider as the Board considers action on legislation.

Dr. Janice Stanger and Mr. Bob Blum of Mercer, Inc. will present their findings and answer any questions about the Optional Supplemental Benefits Study.

STATE TEACHERS' RETIREMENT SYSTEM

Benefit Feasibility Study:
Final Report and Recommendations

Prepared by:

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January 1998

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Overview of the Project

STRS is considering the addition of supplemental benefits to its core pension programs. These supplemental benefits would provide value to STRS members and constituent districts by using STRS group purchasing power to offer quality services and coverage at competitive prices.

In order to determine which supplemental benefits to add, STRS has worked with William M. Mercer, Incorporated to conduct a benefit feasibility study. This study consists of the following steps:

Phase I	Obtain input from school districts and constituent groups. – Conducted meetings and/or telephone interviews with 7 major constituent groups – Surveyed 123 districts; 51 districts responded (41.5% response rate)
Phase II	Obtain input from active and retired STRS members – Surveyed 1,000 active members and 980 retired members – Response rate (excluding undeliverable surveys): * 21.9% active members * 53.6% retired members
Phase III	Conduct market analysis – Include (as applicable) market availability, typical enrollment levels, providers to be considered, geographic considerations, major administrative considerations, typical program designs, and typical or sample cost for eight programs still under consideration – Conducted by Seabury & Smith (Mercer sister company) and Mercer based on existing knowledge of the market and telephone calls to some potential providers – Includes eight programs identified during Phases I and II; Mercer added Individual Retirement Accounts (IRAs) to the analysis provided in this report

Previous reports discussed the methodology and findings of Phases I and II in detail. This report discusses Phase III findings and incorporates the market analysis with previous phases to make recommendations for implementation.

Summary of Phase III Findings

Phase III market analysis is provided for the following programs:

- þ Dental coverage (retirees)
- þ Vision coverage (retirees)
- þ Group legal (retirees)
- þ Tax-sheltered annuities (actives)
- þ 457 Plan (actives)
- þ Short-term disability (actives)
- þ Personal liability insurance (actives and retirees)
- þ District negotiated rates through a buying coalition for dental and vision insurance and administrative services (districts could use to provide these coverages to all participants at a lower cost to the district)
- þ Individual retirement accounts (IRAs): added by Mercer as a result of legislation enacted late in 1997 expanding the availability and attractiveness of IRAs effective January 1, 1998 (IRAs are usually for actives, but retirees can use Roth IRAs)

Phase III market analysis is detailed in Appendix 1 (after the summary and recommendation sections of this report). Exhibit 1 on page 4 summarizes Phase III findings using the following criteria:

- þ Availability in the market of services STRS would need
- þ Typical enrollment levels
- þ Administrative complexity

Significant issues which apply to most programs under consideration include:

- þ Adverse selection. Adverse selection occurs when people who are most likely to use a service or have claims under an insurance policy sign up for that program. For example, dental expenses tend to be predictable for most people over a 12 month period. Thus, those most likely to enroll in dental insurance at the beginning of a year are people who are likely to have claims which exceed their premiums. This makes the program unstable because costs will increase each year, and soon only the worst risks will remain in the dental program, which has become financially unattractive to everyone else. The same adverse selection dynamic applies to all potential programs in which there is risk pooling accompanied by some predictability of utilization and individual selection of program participation. In Phase III, the programs most vulnerable to adverse selection are dental, vision, group legal, and short-term disability. Adverse selection is a consideration, but to a lesser extent, for personal liability insurance, due to the catastrophic and generally unpredictable occurrences which would trigger a claim under this program.

- Insurance vs. discount programs for dental, vision, and legal. Insurance provides reimbursement for specified expenses and involves some risk-pooling. Discount programs allow the participant to pay less for services than would be the case if the discount were not available. In addition, insurance may provide valuable utilization review, which is lacking in discount programs.

- Payment method. Phase II research found that active members view payroll deduction as significantly more attractive as a payment method than separate remittance to the program or insurance carrier. For retirees, STRS should consider pension check deduction as a method to make programs more attractive both to retirees and to vendors which might work with STRS in offering the program. Individual billing is so expensive that this administrative cost is prohibitive, at least for dental and vision programs.

- In-depth analysis. The purpose of this benefit feasibility study is to identify programs with the highest likelihood of success if offered by STRS. Further research is needed to design specific programs. For example, if STRS proceeds with dental, should the program be insured or a discount program? Which specific plan features would be most attractive to potential enrollees? What are specific carrier requirements on enrollment rules? We recommend STRS thoroughly research each program to be implemented to ensure its success. Research can be conducted through focus groups, surveys, and the RFI or RFP program.

- Niche programs. Most programs identified in this Phase are niche programs that meet a specific need. Typical enrollment in similar programs is a small fraction of total association membership. Such programs can still be quite valuable for members who do choose to enroll, providing the flexibility to meet the changing needs of a diverse membership.

Exhibit 1. Phase III Summary Chart

Program or Service	Market Availability to STRS	Typical Enrollment Levels	Administrative Complexity
Dental coverage (retirees)	++	++	+/–
Vision coverage (retirees)	+	+	+
Group legal (retirees)	+	–	+
Tax-sheltered annuities (actives)	++	++	– –
457 Plan (actives)	unknown	– –	+/ –
Short-term disability (actives)	–	– –	–
Personal liability insurance	+	– –	– –
IRAs	+	unknown	+/–
District buying coalition	+	–	– –

Recommendations for Implementation

The following are Mercer's recommendations with regard to the ten programs still under considerations. These ten programs include the eight programs initially included in Phase III, IRAs, and additional retirement service credit.

Programs to Offer: Higher Priority

Criteria for inclusion:

- Have strong union and district support
- Members indicate strong interest
- Marketplace success is likely
- Closely fit core STRS mission to provide retirement security

Programs:

- Purchase of additional retirement service credit
- Roth IRAs on a payroll deduction basis
- Dental coverage for retirees (may be bundled with vision)

Programs to Offer: Lower Priority

Criteria for inclusion:

- Have union and district support (but less strong than for higher priority programs)
- Members indicate interest (but less strong than for higher priority programs)
- Marketplace success will take more effort
- Good fit with core STRS mission

Programs:

- Vision coverage for retirees (if not bundled with dental)
- Tax-sheltered annuities with emphasis on providing employers with compliance and administrative services (actives)
- After tax voluntary contribution to a 401 (a) plan (actives)

Programs to Terminate from Consideration at This Time

Criteria for inclusion:

- Lower level of union and district support
- Member interest not as strong as for priority programs
- Marketplace success will be difficult to achieve
- Poorer fit with core STRS mission

Programs:

- Group legal for retirees
- Short-term disability for actives
- Personal liability insurance
- District buying coalition
- After tax 457 plan

These programs could be reconsidered at a later date as the marketplace evolves and member interests change.

Appendix 1. Market Analysis

Dental Coverage (Retirees)

Market Availability

Voluntary dental insurance has made a comeback. Following large losses in the 1980s, insurance companies are returning to the marketplace with voluntary insurance which is structured to reduce the negative impact of adverse selection, which was a significant problem in the earlier cycle. The typical current voluntary dental insurance program uses waiting periods, payment limits, and provider networks to reduce adverse selection risk. These programs also provide valuable utilization review to prevent unnecessary services, thereby protecting the member.

In addition to traditional dental insurance "discount programs" have been developed using networks of providers to achieve savings for participants. These programs include discounts not only on routine care, but also on more extensive treatments such as fillings, crowns, root canals, dentures, etc. This analysis will profile two such programs which achieve savings by channeling participants to professionals who accept reduced fee-for-service agreements. These plans have no claims forms to complete. The program participant is simply identified with an ID card.

Another option in voluntary dental programs that is becoming more prevalent, particularly in California, is managed care plans similar to those available in medical programs. Preferred provider programs provide one level of benefits if the participant sees a network dental provider and a lower level of benefits for a non-network provider. A Dental Health Maintenance Organization (DHMO) or prepaid program is structured in a manner very similar to a medical HMO and requires that the insured access only designated providers who are affiliated with the DHMO in order to obtain benefits. Otherwise no benefits are payable.

DHMO benefits are provided at 100% for most basic services, with copayments required on others. While the premiums for such plans can be as low as $8-$12 per member per month, extreme care must be utilized in selecting this option. In general, provider listings are very limited even in urban areas, and many listed providers are not taking new patients or make it very difficult for patients to get services. DHMOs usually offer no protection against the supply of high copayment but unnecessary services to patients. The quality of care delivered by some DHMOs is still uneven.

Dental discount programs are also widely available. Credit card companies, insurance companies, and financial institutions are using dental discount programs to strengthen their affinity with their customers and attract potential customers.

Typical Enrollment Levels

Voluntary dental insurance programs reviewed are achieving 5% to 10% participation. Those programs with older audiences are experiencing participation closer to 10%. The discount programs (which are in most cases a bundling of several discount services for several types of health care services) are achieving 12% to 15% participation, but experience a high turnover rate of participants.

Product Providers To Be Considered

The following are sample providers; several other providers are available.

Gerber Life Insurance Company of White Plains, New York, is a leader in the voluntary dental insurance market. This company is rated A- (Excellent) by Best. Gerber provides an insured product which allows the insured to select the service provider.

Other insured programs in the marketplace include Security Life Insurance Company and Allianz Life Insurance Company.

US Life Insurance Company provides a reduced fee-for-service dental plan which is not an insurance program. This means the participant pays a specified fee for dental services performed by a dentist in the network. This type of discount plan lists the covered dental procedures and services and their reduced fees. Any procedure not listed on the fee schedule is reduced by 25%.

Discount Development Services (DDS) has developed discounts which can be up to 40% depending upon type of dental care and region. DDS can provide a discount dental plan, but more typically a number of discount services (for example dental, vision, prescription drug, chiropractic) are packaged together.

Special Considerations By Geographic Location

Careful review of provider networks should take place before selecting an insurance or discount program. The availability of providers in rural areas can be a significant issue with retired groups since many retirees seek out lower cost of living areas in which to live. The strength of provider networks in traditional “snowbird” locations outside of California should also be considered.

The cost of services can vary from urban to rural areas. Some dental insurance plans use specific dollar allowances based on “service areas”. A review of these “service areas” to determine the appropriateness of the boundary lines would be prudent, particularly since California tends to be a higher cost area vs. the rest of the country.

Major Administrative Considerations

The limitations placed on dental insurance programs and the confusion that can arise between an insured program and a discount program dictate a high level of information distribution and customer service in the administration of either program. Programs using networks create additional administrative considerations because people have questions about network participants and want directories of providers. Any program provider selected should have the capability to mail directories to insureds upon request.

Many dental insurance and dental discount programs involve multiple administrators. An effort should be made to determine how strong the lines of communication are between these companies.

Description of Typical Program Benefits and Costs

	Gerber Life	**US Life**	**DDS**
Type of Plan	pays a percentage of U&C	reduced fee-for-service discount	discount program

	Gerber Life	**US Life**	**DDS**
Annual Deductible per person	$50 < age 60 $100 age 60 or over	None	None
Max Benefit	$1,500 < age 60* $1,000 age 60 or over**	None	None
Waiting Period	1 year for Special and Major services	None	None
Choice of Dentist	Yes	No, but over 6,000 participate nationally	No, but more than 13,000 participate nationally
Vision	Rider Available - pays scheduled dollar amount per service	No	Yes, also a discount program
Orthodontics	Rider Available - pays scheduled dollar amount per service - additional waiting period 18 months	Yes, reduced fee-for-service	Yes, also discount program
Typical Quarterly Rates	Member $76 Mbr+Sps $151 Mbr+Chd $120 Mbr +Family $194	Member $15 Mbr+Sps $27 Mbr+Chd $27 Mbr+Family $39	Member or Family $12

* *$750 for Special or Major services*
** *$500 for Special or Major services*

Conclusion

Dental has good potential for marketplace success. STRS could consider providing two options to provide retirees with a choice to meet their needs, probably a high (insurance) and low (discount) option that is differentiated by cost. To reduce risk, dental insurance should, at least initially, be fully insured by a third party. Otherwise, pension funds would be placed at risk.

Visions Coverage (Retirees)

Market Availability

Voluntary vision insurance is not widespread in the marketplace. There are vision riders available as an additional coverage with dental insurance, but few stand alone vision insurance policies. In contrast vision discount programs are included in virtually every health care discount program being marketed, plus there are many separate "vision care" discount plans.

Typical Enrollment Levels

No information was available for enrollment in voluntary vision insurance programs as a stand alone product. The information provided for dental insurance enrollment is mirrored by the vision insurance as a rider to a dental insurance policy or part of a package of discounted health care services and products. So the insurance achieves 5% - 10% enrollment and the discount programs achieve 12% - 15% enrollment.

Product Providers To Be Considered

Gerber Life Insurance has a vision rider which could be added to their dental insurance policy. The coverage is limited, but it provides a benefit at a low cost.

Eye Care International, Inc. (ECI) provides one of the national's largest network of ophthalmologists and optical outlets that offer their services and products on a non-insurance discount fee-for-service basis. This discount is also available for services such as cataract surgery. Physicians in the network use the national Medicare fee schedule as a base and reduce the Medicare allowable rate by 20% for ECI members.

Discount Development Services packages vision services in a bundle of health care discount services. Using a network of 7,000 eye care professionals nationwide discounts of up to 45% are available on eyeglasses, contact lenses (excluding disposables), non-prescription sunglasses, and in some locations eye examinations.

Special Considerations By Geographic Location

Just as with the dental insurance, special attention should be paid to the network providers. The urban/rural availability issue can be important. A program such as ECI's which touts its tie to ophthalmologists may need a more extensive review because of the level of specialization of the providers.

Major Administrative Considerations

The programs using provider networks must have strong call center operations to respond to inquiries about network providers. This is also important when a program such as ECI's provides a benefit based on a program such as Medicare. The program participants may need additional information about how this benefit is calculated.

Description of Typical Program Benefits and Costs

	Gerber Life	**ECI**	**DDS**
Type of Plan	Pays a specific fee for covered service	Reduced fee-for-service discount	Discount program
Annual Deductible per person	None	None	None
Max Benefit	Scheduled by service. Total maximum possible based on highest priced services is $130 per 24 months	None	None
Waiting Period	6 months	None	None
Choice of Provider	Yes	No, but more than 10,000 participate nationally	No, but more than 7,000 participate nationally
Examinations	Comprehensive (1) per 24 months with plan paying $35 or $25 (Ophthalmologist or Optometrist) Follow -Up (1) per 12 months with plan paying $20 or $15.	20% savings on routine eye exams.	Discounts available in some locations.
Eyewear	One set per 24 months. Schedule is Single vision $30 Bifocal $35 Trifocal $40 Contacts $75 Frames $30	20% - 60% savings	20% - 50% savings
Medical Services	None	20% off the national Medicare fee schedule for coded procedures	None
Typical Quarterly Rates	Blended with Dental Insurance Rates	Member $40 or Family	Member $12 or Family

Conclusion

If a dental insurance program is implemented then the vision rider might be added for its marketing appeal and extra value for retirees.

The vision discount program featuring medical services at a discounted rate is worthy of strong consideration for a retiree group. The structure of the ECI type program has special appeal with its discount from Medicare charges.

Both options could be made available, although with increased administrative and communications complexity.

Group Legal (Retiree)

Market Availability

Legal services are available as insured plans, prepaid service plans, and discount plans. The pricing for these plans vary widely based on the available services. The emphasis for legal plans have been for employer sponsorship rather than voluntary individual or association sponsored programs.

Typical Enrollment Levels

Demand for legal insurance programs for retirees is closely tied to whether this benefit had been available during employment. Enrollment levels for insured plans range from 0.5% to 1.5% while prepaid services and discount programs experience enrollment of 2% to 3%.

Special Considerations By Geographic Location

State laws and the tendency for legal action should be factored into selection of the benefits for a legal program. The quality and distribution of the network which will be used in providing services must be considered.

Major Administrative Considerations

Legal programs use several methods of channeling program participants to attorneys. Programs use centralized call centers to direct participants to local lawyers or provide basic "hot line" services. Once again, the quality of the administrative services should be a major consideration.

Description of Typical Program Benefits and Costs

	Midwest Legal Services	**Pre-Paid Legal Services**	**DDS**
Type of Coverage and Cost	Insured (indemnity) $14.50/Month	Pre-paid service and discount $2.50/Month	Discount $1.40/Month
Network	Freedom of choice of any network (pays 100% of covered services) or non-network attorney (dollar limits applied to services)	Yes (network coverage only)	Yes (network coverage only)
Telephone Legal Advice	Yes	Yes	No
Will Preparation	Included	Included	Discount only
Estate Administration	Included	Discount only	Discount only
Defense of incompetency proceedings	Included, in the second year of participation	Discount only	Discount only

Conclusion

Legal programs are not as widely available as health care programs and generally experience significantly lower enrollment rates.

Short Term Disability (Active)

Market Availability

Disability plans are offered by both the major educator unions, National Education Association (NEA) and American Federation of Teachers (AFT). The NEA plan has short waiting periods similar to a Short Term Disability (STD) Plan, but the benefit periods are actually Long Term Disability (LTD)periods. AFT has one plan that is a STD plan, plus an LTD plan.

Typical Enrollment Levels

Participation in the existing NEA and AFT sponsored plans is low (estimated at less than 1%). Contacts with providers of this coverage indicate that the short term disability is a difficult sale. Generous sick leave policies have reduced the perceived need for the coverage in the view of most teachers.

Product Providers To Be Considered

Current providers in the marketplace are American Fidelity Assurance Company and Washington National for NEA and Allianz Life Insurance for AFT. In addition, companies such as Standard Insurance Company, Fortis, and Provident are in the STD market.

Special Considerations By Geographic Location

This coverage may have more appeal in areas with more conservative sick leave policies. STRS would need to ascertain if there were areas in which sick leave benefits are less generous than is the case in most of California.

Major Administrative Considerations

The AFT program provides STD as a choice in an overall disability program which includes Long Term Disability (LTD). Insurance carriers may be less willing to offer STD stand alone. An STD policy would need to coordinate with the claimant's employer, increasing administrative complexity.

Description of Typical Program Benefits and Costs

	American Fidelity NEA/LTD	**Washington National NEA/LTD**	**Allianz Life AFT**
Eligibility	Working 15 hours per week or more	Working 20 hours per week or more	Actively working and under 60 years of age
Benefit	$100 to $6,000 per month not to exceed 2/3 of annual salary	$100 to $6,000 per month not to exceed 2/3 of annual salary	$200 to $5,000 per month not to exceed 2/3 of annual salary
STD Waiting Period	1st day of accidental disability and 4th day of illness disability	11th day of disability	31st day of disability
Benefit Period	Age 67 or five years whichever is greater, but not beyond age 72	Age 65	One year
Benefit Coordination	Benefits are reduced by other benefits received for the disability	Benefits are reduced by other benefits received for the disability	No coordination
Minimum Monthly Benefit	25% of the selected monthly benefit	25% of the selected monthly benefit	None
Spouse Coverage	No	No	Yes

Rate Example for Semi-Annual Premiums for Each $100 in Monthly Benefits:

Under 30	$3.30
30-34	$4.00
35-39	$5.20
40-44	$6.40
45-49	$7.50
50-54	$8.70
55-59	$10.80

Conclusion

The market for a short term disability program is limited. If the major educator organizations are not offering the coverage or have low participation, this indicates market success could be difficult to achieve.

Personal Liability Insurance

Market Analysis

Many insurance companies provide personal liability insurance (also known as personal umbrella policies) in conjunction with their personal auto and homeowner insurance policies. In today's insurance marketplace individuals very often choose to have their homeowner and personal auto policies with different insurance companies.

There are "stand alone" personal liability policies available in California. These policies do not require that either the personal auto or homeowners insurance be written by the insurance carrier providing the personal liability coverage. These types of plans do have very specific requirements for minimum required limits of liability for underlying personal auto, homeowners, farmowners, recreational vehicles, and watercraft insurance policies. In addition, the coverage eligibility is specific with limits on the number of licensed vehicles, number of residential properties, number of watercraft, number of drivers (and limits for certain ages; under 26 or over 70), number of moving violations for all drivers in the last three years, and number of "at fault" accidents for all drivers in the past three years.

Typical Enrollment Levels

Participation in known sponsored plans is low (estimated at less than .5%). The groups which could provide information about their program were relatively new marketing efforts. The company providing the coverage has not aggressively marketed to sponsored plans, but rather has distributed the product through agents.

Product Providers To Be Considered

The most active provider of "stand alone" Personal Liability coverage is RLI Insurance Company. RLI's product is marketed by the Independent Insurance Agents of America (IIAA) through their member agents. The coverage could be marketed through direct mail.

Special Considerations By Geographic Location

Pricing is tied to geography with insurance carriers setting prices based on geopolitical lines such as zip codes.

Major Administrative Considerations

The underwriting standards for this type of product can be very specific. The application creates an information matrix and individuals with criteria outside of the matrix are not eligible for coverage. The applicant either meets the required guidelines or does not; there is no individual underwriting. A "stand alone" personal liability plan should be publicized as a plan for "preferred" participants. Unless the plan is presented in this manner the volume of comments will be high from members disappointed because they fall outside the plan guidelines.

Description of Typical Program Benefits and Costs

Eligibility	Based on age and underwriting criteria
Available Coverage Limit	$1,$2, and $3 million
Required Auto Limit (w/young drivers under 26)	$500,000/Bodily Injury/Each Person $500,000/Bodily Injury/Each Occurrence $100,000/Propoerty Damage/Each Occurrence

(no young drivers)	or $250,000/Bodily Injury/Each Person $500,000/Bodily Injury/Each Occurrence $100,000/Property Damage/Each Occurrence
Required Homeowners	$300,000 each occurrence is mandatory
Farmowners	$300,000 each occurrence
Unlicensed RV	$100,000 each occurrence
Watercraft Under 26 ft and 50 HP Over 26 ft and over 50 HP	 $100,000 Combined Single Limit $300,000 Combined Single Limit

The pricing for this coverage is many times "tiered" (Preferred, Standard, and Standard 2) to accommodate as many needs as possible. Shown below are examples of rates for a "stand alone" personal liability plan:

Personal Liability Rate Example

		Urban	Suburban	All Other
$1 Million				
	Preferred	$275	$255	$205
	Standard	$450	$380	$300
	Standard2	$585	$495	$390
$2 Million				
	Preferred	$509	$472	$379
	Standard	$833	$703	$555
	Standard2	$1,082	$916	$722
$3 Million				
	Preferred	$688	$638	$513
	Standard	$1,125	$950	$750
	Standard2	$1,463	$1,238	$975

California Rates

for RLI Insurance Company

Conclusion

The stand alone personal liability program can be complex to communicate and administer. There is little prior association sponsorship experience available which can be used to determine what is necessary to sponsor a successful program.

457 (Deferred Compensation) Plans

Market Availability and Typical Enrollment levels

457 plans generally are available from most public sector employers. However, the tax rules generally provide lower tax deferral contribution limits for employees who participate in 403(b) plans and 457 plans simultaneously, or who participate only in a 457 plan instead of a 403(b) plan. (The dollar limits are lower in 457 plans but the percentage limits can be higher.) Our experience, mostly anecdotal, is that participation rates in 457 plans are usually quite low for school district employees.

Product Providers

Most consumer oriented mutual funds and life insurance companies have 457 plan products. Of course, CalPERS offers a 457 plan for local agencies.

Costs and Returns

Because of the number of product providers and the wide range of products (mutual funds, annuities, and investment funds of an extraordinary variety and flavor) it does not appear that, in this project, we can provide useful information on costs and returns beyond what the SRS investment office already has. If costs and returns become important for ultimate business decisions, we would want to work with you to set assumptions and parameters and then we could provide STRS with detailed market information.

Special Considerations — After Tax Voluntary 457 Plan

Most 457 plans that are offered on the market are based on tax deferral of the participant's contributions. However, as stated above, the tax deferral contribution limits for 457 plans is lower than that of 403(b) plans and every STRS member has access to a tax deferred 403(b) plan.

After tax voluntary contributions to a 457 plan are available under the tax laws, however. The earnings on such contributions should be tax deferred until they are paid or made available from the plan. Therefore, it might be useful to consider providing a 457 plan only for such contributions.

There are two critical issues here, however. The first is tax uncertainty. The IRS has previously and informally indicated that it might not treat the earnings on after tax 457 plan contributions as tax deferred. While this seems to be the clear rule under the governing regulations, nevertheless because of the IRS comments, there is some uncertainty about this issue. Additionally, some have raised a question about whether a 457 plan comes within these regulations if the only contributions to the plan are after tax. While it appears that the better argument is that such a 457 plan should be covered by the regulations, nevertheless certainty can only be obtained from the IRS through a ruling or other advice.

In this tax situation, an after tax 401(a) tax qualified plan should be better than an after tax 457 plan. An after tax 401(a) plan would not present these, or equivalent, tax issues.

The second critical issue is whether there really is a market for this type of plan. This issue is heightened because of the newly enacted Roth IRAs. Generally, with a Roth IRA, an individual can contribute up to $2,000 per year on an after tax basis and the earnings are not only deferred but also distributed tax free, under easy to meet conditions. This contrasts with the tax treatment of an after tax

457 or 401(a) plan, where the earnings are tax deferred but they are taxed on distribution. With this contrast, there is little reason (though there is some) for a person to invest in an after tax 457 or 401(a) plan instead of a Roth IRA, at least up to $2,000 per year of contributions.

Therefore, we recommend that STRS consider an after tax 401(a) plan instead of an after tax 457 plan, but also consider this as a secondary priority and consider providing Roth IRAs (and deductible IRAs and deductible spouse IRAs) as a first priority. A separate section of this report describes these savings vehicles.

403(b) Plans (Tax Sheltered Annuities or TSAs)

Market Availability

It is likely that every employer that contributes to STRS makes available to its employees a voluntary 403(b) plan funded solely by voluntary employee contributions. In our experience, many school districts offer a large number of TSA vendors for investment, as many as 200 in some cases. The districts usually consider that their only obligation for these programs is to provide payroll deduction and payment to the vendor selected by the employee.

Typical Enrollment Levels

This varies by school district. Typically, throughout the U.S. we find voluntary public school enrollment levels of 20 to 40 percent of employees.

Product Providers

Most consumer oriented life insurance companies and a limited number of mutual funds have TSA products. Of course, STRS also provides a TSA for its members through some of these same companies.

Costs and Returns

Because of the number of product providers and the wide range of products (mutual funds, annuities; and investment funds of an extraordinary variety and flavor), it does not appear that, in this project, we can provide useful information on costs and returns beyond what the STRS investment office already has. If costs and returns become important for ultimate business decisions, we would want to work with you to set assumptions and parameters and then we could provide STRS with detailed market information. Clearly, however, a purely voluntary arrangement in which many companies only get a very small market share attracts the most costly products and/or the most inconsistent compliance.

Special Considerations -- Tax Compliance

The TSA market is an unusual one for tax favored savings. In most other cases, the employer and/or vendor that sells a tax favored savings product takes great care to ensure that the tax favored status is established at the outset and is maintained. Often this requires strict adherence to very complex rules.

For TSAs, however, historically all parties have taken a hands off position on tax compliance. The employer has considered itself to only the responsibility of payroll deduction and payment to the vendor. The vendors also have disclaimed any responsibility for tax compliance. There has been no one watching the store. This occurred for several reasons. The school district employer did not have the resources to comply with any but the most basic tax requirements (such as a dollar limit on the amount of income deferred each year). The vendors were not responsible for, and did not have data on, all of the deferrals for the employees so, as a practical matter, it was very difficult for them to take responsibility for many of the tax compliance rules. Further, the IRS ignored TSAs for many decades, and therefore there was no reason for anyone to worry about tax compliance.

Recently, however, the IRS' attitude and action has changed. The IRS has audited a number of TSAs, found most of them out of compliance with the tax law, and in some cases has imposed substantial penalties on the employer (in lieu of retroactively taxing the employees on their contributions to the plan).

In addition, the IRS has announced that it will continue to audit TSAs for tax compliance and has made pronouncements that public school districts will be audited for this compliance.

We have had discussions with a number of public school districts about these issues and have found that they are concerned about the possibility of tax audits and the consequences, but that they believe that they do not have the resources to institute compliance programs, even on a going forward basis. For the most part, vendors are not willing to take over compliance responsibility for the employer's entire program (often they just do not have the requisite data and/or cannot control the actions of employees who use several vendors), though some of them will perform critical calculations that set the tax limits for individual employees.

Analysis and Recommendation

In the TSA market, there are two possible paths for STRS to take. It could consider that its primary customer is the employee, and then compete with every existing (and new) vendor on the basis of returns, expenses and reputation. To date that type of competition has not been very successful for STRS (compared to the major vendors) though it can be revitalized.

<u>Employee as the primary customer</u> **--** STRS has suggested that it might consider establishing one or more registered mutual funds because its expenses would be substantially lower than those of other vendors. For some consumers, the expenses charged by vendors will be of substantial importance; for others, they will not be. One easy comparison is Vanguard and Fidelity. Vanguard makes a point of having low expenses; Fidelity does not, and its expense level has shown this. Both compete successfully. In the 403(b) market another key, beyond expenses, is whether the arrangement maintains some administrative compliance, as well.

Competition on the basis of expenses assumes that returns are as good as the competition, and that the consumer understands this. STRS needs to evaluate how is it perceived by consumers with respect to returns; we have no data on that issue. However, anecdotes suggest that, currently, the perception of STRS investment ability might not be high, principally because of the relatively recent public concerns stated by at least one STRS board member. If there are such perception issues, the market barriers may be high to STRS successful entry on the basis of returns. The soft side of the issue is the brand name recognition Fidelity, Valic, or STRS brings to the sales equation.

It may not be necessary for STRS to compete on the basis of returns. For some fund categories, returns may be very close for all funds in the category (e.g., possibly all money market funds or all Fortune 500 Index funds). If this is the case, competition primarily on the basis of expenses may be a good strategy. To the extent that consumers do not agree that returns are essentially the same, or to the extent that they do not perceive expenses as being sufficiently important a basis for choice of funds, this strategy will not work well.

Expenses and investment performance may still not be enough. The market culture may still require agents to provide investment advice and to assist in competing the appropriate forms and helping with loan and hardship withdrawal issues.

If STRS provides registered mutual funds as investment vehicles, and if STRS cost structure gives it a substantial competitive advantage, and if the types of funds that it offers are perceived by the consumer as providing high returns or substantially the same returns as all other funds in the same categories, then STRS may well have a viable market strategy to attract individual customers. However, there are a number of unknowns to this strategy. Therefore, we recommend that STRS do additional market research on this strategy before investing in it.

School Districts And Other Employers As The Primary Customer -- A different strategy for STRS would be to treat the school districts and other employers as its primary customer. In this case, STRS would seek to differentiate itself from the other vendors by providing the employers with services that they highly value but that would not cost STRS anything additional.

One possible differentiator might be tax compliance. If the employers believe that tax compliance is important, and if this service does not cost the employer anything additional, then there may be a substantial incentive for the employer to allow STRS to sponsor a limited number of preferred vendors, or at least to encourage employees to invest with STRS.

In the right conditions, STRS might be able to provide to the school district, at no additional cost to STRS and for all of the employees who invest through STRS exclusively, the full range of tax compliance services. This would include, e.g., MEA (maximum exclusion allowance) calculations, 402(g) limit calculations, 415 limit calculations, plan loan administration and hardship withdrawal administration.

For this to occur several conditions would be required. First, STRS would have to be the single investment point for the employees; only in that way could it have sufficient control and data to provide this administration. Second, for STRS to be the single investment point, it would have to offer a sufficiently wide range of investment options with attractive returns and expenses. This might be done by STRS offering a sufficient number of investment options (possibly from a number of vendors) that it had thoroughly vetted. Third, STRS would have to be able to charge the vendors whose funds it offered, or the participants themselves, an administration fee. This would be set at a rate that would eliminate STRS costs for this service. (For example, one dollar per person per month.)

We do not know of any State teachers retirement fund that offers this service. We know of one teachers' association that acts as a single remitter and negotiates a better product with approved vendors, but does not provide the compliance component. We would characterize its success as modest, primarily because it too is competing with other vendors in the market place.

There are a number of unknowns for this strategy, including the interest of the school districts and other employers, the ability and interest of the employers to give STRS prime vendor status and/or encourage employees to treat STRS as the vendor of choice, the ability of STRS to provide the tax compliance and administration services, the cost of those services, and the willingness of vendors and/or participants to pay for these services. Therefore, we recommend that STRS do additional market research on this strategy before investing in it.

STRS SPONSORED ROTH (and other) IRAs

Members and Retirees Desire Additional Retirement Savings Opportunities

STRS members indicated on the Phase II survey that they are interested in additional retirement savings opportunities. These preferences were stated even though every STRS member has access to a 403(b) plan now, and it is likely that many STRS members have access to a 457 plan (although generally a 403(b) plan allows greater tax deferral).

STRS Sponsored 403(b) or 457 Plans Provide Substitutes, Not Additional Opportunities

Because STRS members and retirees already have access to 403(b), and likely 457, plans, any new 403(b) or 457 plans will be substitutes for existing savings opportunities, not additions. They also may provide better performance because the new plans may be more cost efficient or provide the likelihood of better returns. Therefore, they may be better than a substitute.

We recognize that an after tax 401(a) or 457 plan is an addition, not a substitute. However, as discussed in the section on 457 plans, it seems that Roth IRAs are more attractive than these programs, at least up to $2,000 of savings annually.

STRS Sponsored IRAs Would Provide Additional Retirement Savings Opportunities

Federal tax law provides for several different types of IRAs, each of which is *in addition* to any 403(b) or 457 retirement savings that STRS active members or retirees are able to make. Therefore, if STRS sponsors IRAs for its active members and retirees, it will be providing a new retirement savings opportunity, not just substituting for what already exists through the employer.

It is possible that some school district and other certificated teacher employers provide IRAs now, but most likely there are few such programs. The reason is that IRA sponsors have not focused on the employer based market, but have focused on the individual consumer market. The reason for this, in turn, is that many employers in the private sector have shunned IRAs either because there is a concern that they will become an ERISA plan with substantial regulation – not an issue for the public sector – or because 401(k) plans are better for their retirement programs. STRS may wish to consider some supplemental research to check whether our perception is correct, if it is interested in the IRA market.

There are 3 IRAs that are usually of most interest: the new Roth IRA, the deductible IRA, and the spouse IRA. Generally, each allows an annual contribution of $2,000 *in addition* to the individual's 403(b) or 457 deductible contribution. Contributions to a Roth IRA are after tax, but the earnings are distributed tax free. Contributions to a deductible IRA and a spouse IRA are tax deductible; distributions are taxable as ordinary income. Each of these IRAs has an "income phase-out", so individuals with income over a stated amount cannot participate. The deductible IRA has the lowest level income for phase out; the spouse and Roth IRA have quite high income levels for phase out and therefore are usable by the vast majority of taxpayers. Each is summarized below.

We do not have survey data on member and retiree interest in STRS sponsored IRAs. We are assuming that the data showing an interest in additional retirement savings opportunities would have included an interest in IRAs sponsored by STRS. (Roth IRAs first became available on January 1, 1998, and the expanded opportunities for spouse IRAs also first became available on that date.) STRS may wish to consider some supplemental research to check whether our perception on potential IRA interest is correct.

STRS Sponsored IRAs Probably Would Be Unique in California

We know of no other California (or outside California) public (or private) retirement system that sponsors IRAs. STRS would be unique and a market leader if it undertook this action. Of course, many financial institutions sponsor IRAs and it appears that TIAA/CREF may enter this market.

IRAs Are Relatively Easy to Administer

There are many fewer tax rules and limitations on IRAs than on 403(b) and on 457 plans and they are easier to comply with. In addition, the IRS provides sample master documents that a sponsor can use, simplifying the legal and IRS approval process.

If STRS sponsored an IRA with investments "run" by STRS, then it is likely that STRS would have to register the funding vehicle with the SEC. However, STRS may be able to sponsor a set of IRAs, with diversified investments and several financial institution sponsors. That would simplify the administration for STRS but also might not provide as much "STRS identity" for the program.

The IRS May Be Inclined to "Bless" Payroll Deduction IRAs

Payroll deductions for IRA contributions may be most convenient for STRS members as well as for STRS itself. Payroll deductions for IRA contributions also should distinguish STRS in the market. Further, the IRS may be inclined to formally "bless" a payroll deduction IRA because the Congress suggested this in the legislation that enacted Roth IRAs.

IRAs Summarized

Roth IRAs -- Contributions to a Roth IRA are made on an after tax basis; the maximum annual contribution is $2,000. Earnings on these contributions are wholly tax free if they are distributed as "qualified" distributions. To be qualified, a 5 year holding period (period during which the funds remain in the Roth IRA) must be met, and certain distribution timing rules also must be met (e.g., after age 59 ½; to a beneficiary after the individual's death; on disability, or for "first time home buyer expenses". The phase out for being able to use a Roth IRA is AGI of $150,000 - $160,000 for joint return filers and $95,000 - $110,000 for single taxpayers.

Deductible IRAs **--** Contributions to deductible IRAs of up to $2,000 (or taxable income if lower) are tax deducible. IRA account earnings are not currently taxed. Both the contributions and earnings are taxed at distribution.

For many years, individuals who were covered by another tax favored retirement plan (such as STRS or a 403(b) plan) could not contribute to an IRA. Recently that was changed, and retirement plan members can contribute and take deductions under limitations.

The most important limitation is that the ability to deduct contributions to an IRA phases out at federal adjusted gross income (AGI) of $50,000 - $60,000 (completely phased out at $60,000) for 1998 for married filing jointly. For single taxpayers the range is $30,000 - $40,000. The phase out limits will increase each year so, e.g., it reaches $80,000 - 100,000 for married filing jointly in the year 2007.

These phase out rules limit the market for these IRAs for STRS members; some supplemental research may be appropriate to determine the practical effect of the phase out rules. Alternatively, from its retirement plan data, STRS may know the number of certificated teachers who are below the critical income limits.

Spouse IRAs -- A spouse IRA works the same way as a deducible IRA with two critical differences. First, the fact that individual's spouse is an active participant in another tax favored retirement plan is ignored for determining the limits on the individual's deductible contributions. This is new law; prior to January 1, 1998, if a spouse participated in a tax favored retirement plan that was also wholly attributed to the individual.

Second, the phase out AGI is much higher for a spouse IRA. The ability for a spouse to make deductible contributions to an IRA phases out between $150,000 and $160,000 of federal AGI. This also is new starting on January 1, 1998. (If both spouses are covered by another retirement plan, the deductible IRA phase out rules apply to both.)

District Dental/Vision Services Purchasing Coalition

This program is substantially different from the other programs under consideration in Phase III. The purchasing coalition would be a service for districts to provide existing dental coverage to all insureds at a lower cost. The program is not directly offered for active or retired members. The Phase I district survey found the following key results on which this potential program is based:

- 37% of districts offer dental benefits and 48% offer vision benefits independently of other districts (not through a Joint Power Authority (JPA))
- 85% of districts use Delta Dental to administer or insure the dental program
- 84% of districts use VSP to administer or insure the vision program

This analysis assumes that districts already in a JPA are benefiting from group buying power when negotiating with health plan administrators for dental and vision administrative fees or rates.

Those districts not in a JPA may be providing benefits independently for several reasons:

- The district may prefer to deal with the administrator directly rather than through a JPA
- No JPA is available in the district's area
- Some plan design, collective bargaining, or other issue precludes the district from joining a local JPA

Further study would be needed to determine what percentage of districts were not in a JPA because no JPA is available to join. This would be the target market for a STRS-sponsored dental/vision services purchasing coalition.

Administrative challenges in putting together such a coalition include the following:

- Differences in plan design offered among districts. For insured plans, only a few plan designs could likely be accommodated within the coalition.
- Differences in risk among districts. Because of different demographics, levels of employer contributions, availability of network providers and other factors we would expect that costs would vary among districts even for the same plan design. This would make pooling of insured claims costs problematical.
- Administrative costs. The cost to administer the coalition could exceed the savings obtained from negotiating with the health plan vendors. One reason for this is that (unless the coalition establishes its own structure to pay the vendor), the vendor needs to deal with each district separately plus the coalition in addition. Districts with higher per capita utilization would have higher administrative costs, making pooling administrative costs difficult.
- Membership instability. Member districts will join and leave the purchasing coalition on a regular basis as they perceive it is in their self-interest to do so.

In conclusion, this would be a challenging program both to communicate and administer. More study is needed to determine the potential for district cost savings.

Appendix 2. Benefits Considered in Previous Project Phases

This Appendix provides a history of supplemental benefit programs considered during this project. Some potential supplemental benefits were terminated from consideration during the initial planning process, prior to Phase I. For example, long-term care insurance was eliminated at this point because STRS members participate in the PERS program. Programs terminated from consideration prior to Phase I are not listed here.

Programs Terminated from Consideration as a Result of Phase I Findings:

- Teacher training
- Pet health insurance
- Group discounts
- Group travel services
- Loans (note: home loans are being separately considered by STRS)
- Group homeowners insurance
- Accidental death and dismemberment
- Term life insurance
- Long-term disability

Programs Terminated from Consideration as a Result of Phase II Findings:

- Universal life
- Financial planner
- Financial software
- Burial insurance
- Retirement publications

Appendix 3. Summary of Open-Ended Comments on the Retiree Survey

Although not requested by the questionnaire, a number of retirees wrote comments on the Phase II survey. The most frequent comments were:

- The respondent wants medical coverage through STRS;
- The respondent is very old and frail and has no unmet needs;
- The respondent wants increased pension benefits.